Singapore Management University
Institutional Knowledge at Singapore Management University

Knowledge@SMU
Office of Research & Tech Transfer

1-2007

Why Global Banks Are Banking on India

Knowledge@SMU

(http://knowledge.smu.edu.sg)

Why Global Banks Are Banking on India

Published: January 11, 2007 in Knowledge@SMU

Follow the money for a sure bet, they say -- and the world's big and small banks are doing just that in India's juggernaut economy, whose GDP now approaches $800 billion. Citigroup said last February that it will invest more than half a billion dollars in its Indian operations in 2006; in 2005, it pumped $415 million into its operations there. Others writing expansion checks in India include HSBC, Bank of America, Standard Chartered Bank and Deutsche Bank. Besides organic growth, these banks are expanding in India by buying stakes in private banks and setting up non-bank finance companies.

That India is viewed as one of the biggest growth stories among emerging markets explains only part of the attraction for foreign banks. The country's central bank has outlined the roadmap for foreign players to grow, allowing them to set up branches in rural India and take over weak banks with an investment of up to 74% -- and promises to do more in three more years. Credit off-take has grown 25%-30% annually in recent years, with most of the new action in retail consumer lending, which tends to be happy hunting ground for foreign banks.

Not everybody in the industry is happy, of course, to see bigger room for foreign banks, which some view as not adequately embracing India's developmental agenda. India Knowledge@Wharton spoke to heads of several leading banks, experts from consulting firms and faculty members from Wharton and the Indian Institute of Management to get insights into the key drivers of the expansive sentiment in Indian banking. Mirroring India's economic bounties, India's banking industry has been on a high since the beginning of this decade, with advances growing annually at an average of 23%. The Indian banking industry is made up of 28 public sector banks, 30 foreign banks and 29 private banks, excluding cooperative banks and regional rural banks.

Advances posted the biggest jump of 31.4% to Rs. 15,13,481 crore (nearly $330 billion) between fiscal 2005 (April to March) and 2006, according to the Indian Banks Association in Mumbai. Net profits of these banks, however, grew only about 17% to Rs. 24,061 crore ($5.2 billion) over the past year. Collectively, they reported Rs. 25,79,980 crore ($561 billion) in assets in FY 2006. Those assets are expected to grow to $915 billion by 2010 representing a compounded annual growth rate of 15%, says the IBA. According to Wharton professor of finance Krishna Ramaswamy (http://www.wharton.upenn.edu/faculty/ramaswak.html), "The fact that there are very profitable private banks since the liberalization in such a short order -- between 1993 and 2005 -- is a testimonial to the fact that people will get very sophisticated in the banking services they demand and receive, whether at the retail or corporate level."

Fine-tuning the Roadmap

In its February 2005 roadmap, India's central bank -- the Reserve Bank of India (RBI) -- said that between March 2005 and 2009, foreign banks that were so far restricted to branch operations could also set up wholly owned subsidiaries. It also said they could buy up to 74% of a private bank, a gray area so far. The guidelines also noted that foreign bank subsidiaries with a minimum capital requirement of Rs. 300 crore ($65 million) would be treated on par with existing branches of foreign banks for branch expansion. However, foreign banks cannot grow unrestrained through local acquisitions; they can buy only weak local banks the regulator identifies. The RBI said the second phase of opening up would commence in April 2009, after "a review of the experience gained and after due consultation with all the stakeholders."

Size or the lack of it remains the key to banks' growth aspirations in India. Little wonder then that the announcement of a roadmap of banking reforms was enough to spur a series of investments. Bank of America, a small and subdued player in India, said it would pump $175 million into its Indian operations. Of that amount, $150 million is already in. The Hongkong & Shanghai Banking Corporation (HSBC) brought in $180 million with another $63 million waiting. Citigroup's planned investments this year include $75 million in Citi Financial, a non-bank finance company, or NBFCs, as they are called; that's on top of $50 million it sent that way last year. (NBFCs can perform most banking functions except accept deposits or run savings accounts.)

Deutsche Bank, too, invested $91 million in its Indian operations over the past year, of which $50 million went into an NBFC. Barclays invested $50 million. Late entrants like Dutch bank ING have been faster on the acquisition track. ING surprised the markets by acquiring a 45% stake of Bangalore-headquartered Vysya Bank, now known as ING Vysya Bank. HSBC had bought close to a 15% stake in UTI Bank and would have gladly gone on to secure a total of 21% had the banking regulator not stopped it early last year. HSBC has since brought down its stake to 4.99% as the banking regulator does not allow any bank to hold more than 5% of another bank without its clearance. HSBC is also considering setting up its own NBFC, regulatory approvals for which tend to arrive faster than those for a new bank or branch expansion.

However, foreign banks like HSBC may not any longer find it easy to float NBFCs. In November 2006, the Reserve Bank of India not only disallowed banks from holding 5% of the equity of any NBFC; it also limited any bank's credit exposure to all NBFCs to 40% of the bank's net worth. Those two measures will effectively frustrate foreign banks' perceived attempts to use NBFCs as de facto branches. Further, the banking regulator also required NBFCs to adhere to capital adequacy norms (these didn't apply to them earlier), restricting the size and structure of their loan portfolio, and a capital adequacy requirement (it didn't apply to NBFCs earlier); it also decided to regulate NBFCs promoted by the parents of foreign banks operating in India on a consolidated basis, and not as independent entities.

India's NBFC industry is both large and fragmented enough for the regulator to keep a close watch. There are 436 deposit-taking NBFCs, of which 16 have asset sizes of over Rs. 500 crore ($112.5 million) and account for 49% of the aggregate deposits of the total NBFC sector. Then come another 2,615 non-deposit taking NBFCs, of which 104 have assets worth at least Rs. 100 crore each. Citigroup heads the segment of non-deposit taking NBFCs, followed by GE Capital and its associates. Ten of these 104 NBFCs account for more than 43% of the total assets of this sector; five of these 10 companies are foreign-owned.

The banking regulator's new guidelines aim at reining in the huge regulatory arbitrage that the foreign players have been enjoying. As the regulator has indicated that the banking sector would not open up before April 2009, foreign banks have been using the NBFC route to add muscle to their balance sheet and expand their activities. This is possible since under the foreign direct investment norms, any foreign player could set up an NBFC once it is cleared by the foreign investment promotion board and the RBI nod in this case is a mere formality (required only to bring in foreign capital.

Citigroup in May 2005 paid $676 million for a 9.3% stake in India's leading mortgage lender Housing Finance Development Corp., taking its total stake in that company to 13%. Others have begun circling. After spending more than a decade as an NBFC doing small retail loans, GE Capital said it wants to buy an Indian bank. Two South African banks, First Rand Bank and Standard Bank are also believed to be eying the country. And not far behind are believed to be UBS of Switzerland and Australia-based Macquarie Bank. Even ANZ, which a few years ago sold its operations in India to Standard Chartered Bank is said to be keen on coming back to India.

Early to Arrive, Slow to Grow

Citibank was late to arrive in India, going by the general benchmark for adventurous foreign banks at that time. After all, it set up shop only in 1902, while the British-owned Standard Chartered arrived 54 years earlier in 1858 (then called Chartered Bank). HSBC came a few years later, setting up shop in 1867. Foreign banks have been around in India for a more century, but stringent controls on market access and expansion restricted their growth. Their presence has been restricted to a handful of branches and representative offices. Citibank India's CEO Sanjay Nayar says banks like his have contributed significantly to the growth and maturing of India's banking sector. "We were the first to introduce credit cards in the mid-eighties and also responsible for pioneering securitization," he says. "Increased access to consumer finance, internet banking and ATMs are other good examples." This is a lead that he obviously does not want to lose.

Nayar's bank belongs to a small universe of 30 active foreign banks in India. Collectively, they earned more than Rs. 3,068 crore ($667 million) in after-tax profits in fiscal 2005-06. Citibank, the most profitable, has 39 branches in 27 cities and covers another 50 through a distribution subsidiary. Its asset book is worth $7.3 billion and it posted an after-tax profit of Rs. 600 crore in 2005 (more than $130 million). Standard Chartered is the largest foreign bank in India with 81 branches in 26 cities. Its asset book of $8.1 billion brought home profits of $131 million in 2005. The business landscape for these banks, however, began to change dramatically with the opening up of the consumer markets in the late eighties and nineties.

Cars, white goods, computers and entertainment electronics suddenly became more affordable as the government steadily lowered tariff levels on both domestic and imported products. The major foreign banks were quick to spot the opportunity, introducing products and services focusing on specific consumer niches like credit cards and car loans.

Private Banks and Their Fortunes

Just as banks including Citibank, Standard Chartered and HSBC began to get a hold on the growing middle class in these niches, two large private Indian banks -- ICICI Bank and HDFC Bank -- arrived on the scene in mid-1990s. They grew rapidly by copying the foreign banks' products, improving and considerably scaling up offerings like mortgages, car loans and credit cards. By comparison, Indian state-owned banks are huge with a market share of 78% of deposits and 73% of advances, but have been losing ground.

Interestingly, in the early 1990s, India's state-owned banks commanded shares of around 85% for both deposits and advances. But privately owned banks have since then snatched away 7% of deposits and 12% of loans and advances from the public sector; foreign banks haven't scored as many gains in the past 15 years. Private banks today boast market shares of 19% in deposits and more than 20% in loans and advances; foreign banks come next with shares of 5% and 7%, respectively. "Foreign banks have ceded territory to the new private banks in the last decade," says K.V. Kamath, CEO of ICICI Bank, the country's largest private sector bank with an asset base of Rs. 2,51,389 crore ($55 billion). "Foreign banks have not been able to seize the opportunity in India. They were not willing to commit capital to the country," he says. "They are now looking for acquisitions of those players who have built scale of operations; it's only natural that the regulator has laid down a roadmap for acquisitions."

The road ahead for foreign banks is clear from the above scenario: Join the private banks' party with strategic stakes, as they wait for more policy latitude to fire their own growth aspirations. The promise lies in those market segments that now account for small shares. Retail lending represents only about 20% of the Indian banking industry's advances and less than 7% of India's GDP of $775 billion, lower than Thailand (18%), Malaysia (33%) and South Korea (55%). India's demographics with its young, consuming class that represent good opportunities are now high in the sights of the foreign banks.

A report from Boston Consulting Group in 2005 on opportunities for foreign banks in India outlined the opportunities. It said 60 million new households should be added to India's bankable segment in three years The report highlighted the fact that only around $35 billion in assets -- less than 6% of GDP -- were being managed "professionally," (meaning the organized banking and financial services industry and excluding the informal sector made up of largely local money lenders). And with more than $180 billion in long term fixed deposits in banks and low penetration in the pension market, the opportunity for sustained double-digit growth is attractive.

Outside the metros, a huge market is in waiting, says Wharton's Ramaswamy. "There is still a very large informal finance sector in India which provides working capital to small businesses," he says, adding, "They are really financial institutions on a modest scale, and they fill the gap." But as banking penetration increases in rural India, Ramaswamy expects the interest rates -- often usurious -- extracted by local moneylenders to dramatically fall. "The customers will get sophisticated and learn that they could perhaps get better rates in the organized sector," he says.

Globalization Will Stay

Boston Consulting Group director and banking industry analyst Janmejaya Sinha sees "the most dramatic impact of globalization" on remote servicing in India of banks' back-office processes. He notes that "the huge improvements in telecommunications and computing technology combined with vast variations in factor costs across the world and tight immigration laws will lead to large shifts in work that doesn't a require customer interface." He says the beginning of this trend is evident mostly in outsourcing of voice-based services. "This is a tide that cannot be turned back," he says. "This will lead to huge improvements in the efficiency of the financial services industry's operations -- both in cost and quality -- and lead to a further integration of the global financial industry."

Tarashankar Bhattacharya, managing director of India's largest bank, the State Bank of India, says he welcomes foreign banks so long as he has a level playing field with them. One of his chief complaints here is while Indian banks have to lend a minimum of 40% of their assets to government-specified "priority sectors" such as agriculture and small scale industries, that requirement is lower at 32% for foreign banks operating in India. Banks don't relish priority sector lending because they come with low profit margins and a high incidence of delinquencies.

Bhattacharya's lament is shared by CEOs of most state owned banks in India. They complain that they are constantly reined in from competing effectively. They cannot, for instance, pay market-linked salaries. Except in rare cases, they are unable to create or hold onto the best talent. They cannot acquire other banks without lengthy and often unsuccessful bureaucratic wrangling. And, as Bhattacharya says, they cannot lend or invest in the booming stock markets as they please. Nor can they raise much needed capital easily. All this, government-owned bankers privately admit, is because they continue to be viewed as instruments of social policy, rather than as commercial institutions by their principal owner, the government. And yes, along with the rest of Indian industry, they cannot downsize at will.

The RBI appears to recognize this. The regulator says a calibrated approach is necessary in the absence of a safety net and labor law reforms. It takes some pride in the fact that India has never faced significant financial sector turmoil like other emerging markets. It wants to ensure consolidation in the domestic sector first before allowing foreign banks a freer entry. The RBI also wants the large public sector banks to merge with each other to create big banks.

Many private banks have taken the cue, albeit with gentle nudges, and have grown with acquisitions. But the big state-owned banks are yet to follow. In September 2005, Indian finance minister P. Chidambaram made a strong pitch for mergers and acquisitions amongst public sector banks. He was speaking at the centennial celebrations of the Bank of India, another large bank. "A country as large as India cannot be content with one large bank (referring to the State Bank)," he said. "Bank of India should lead the way in creating a giant bank which will take on the world's best and biggest." No deal has materialized since.

But the State Bank, which typically sets the ideological agenda for the rest of the banking industry, now openly says that thinking global is critical to domestic success. Last year, State Bank's then chairman A. K. Purwar stated that the bank's goal was to be in the top 50 globally by 2008; it currently holds the 71^{st} ranking in terms of Tier 1 capital (a yardstick used by the Bank for International Settlements in Basel, Switzerland). State Bank's strategy to get higher up the global pecking order is through acquisitions primarily.

The State Bank of India hasn't had much traction in acquiring other Indian banks, but it has made significant strides internationally. It kicked off that effort in February 2005 when it paid $10 million for a 51% stake in Indian Ocean International Bank, the fourth largest in Mauritius. Purwar then said the bank's targets were medium sized banks with assets of $50 million to $200 million each. In the past year, State Bank bought two other banks -- Indonesia's PT Bank IndoMonex and Kenya's Giro Commercial Bank. It is now actively scouting for other acquisitions in Asia and Africa. State Bank's current chairman O. P. Bhatt, however, has said his bank would not acquire small banks any more. "We would buy reasonably big banks if there is a strategic fit," he says.

Citibank's Nayar says globalization forces local banks in emerging-market countries to adopt international best practices in order to stay competitive. These areas include risk management techniques, technology upgrades, more efficient capital allocation tools, focus on marketing and sales and other such areas resulting in improved operating and financial leverage. 'But it is not entirely a one-way street," he says. "There are also areas where international banks are adapting and learning from local best practices, particularly in areas like SME (small and medium enterprises) lending and agri-financing. The main impact is higher efficiency levels in the banking system in terms of more optimal capital allocation, better profitability, prudent risk management and greater competition, which ultimately benefits the end customer through new products and services at affordable prices."

All Roads Lead to Consolidation

Nayar sees consolidation within the banking industry as imperative. "Commoditization of the traditional banking products and the need to invest in technology, marketing and product innovation has made size and scale critical success factors in this industry," he says. "Consolidation is imminent, and foreign banks with their large capital and product expertise can play a significant role in this process." Hrishikes Bhattacharyya, professor of finance and banking at the Indian Institute of Management in Kolkata, doesn't think that's such a good idea. "The Indian financial system is not yet very strong to take on stiff foreign competition," he says. "There is still not a level playing field between Indian banks and foreign banks; the latter does not have developmental obligations like 40% lending to the priority sector where returns are low." Foreign banks are not required to direct more than 32% of their net credit to the "priority sectors" identified by the RBI, which include agriculture, small-scale industries and exports. ICICI's Kamath concedes that over the years foreign banks have contributed to the development of the Indian banking industry in areas like product knowledge and risk management services, but doesn't see any new gains on the horizon. "Frankly, we have nothing to learn from them [now]," he says. "Both in terms of products and technology, we are ahead of them."

Citibank's Nayar says the RBI's approach to opening up the banking sector to foreign investors is well calibrated, but would like quicker branch permissions and access to some government and public sector business. "Foreign banks continue to face constraints in these areas and this significantly impacts their ability to grow their footprint, customer base and restricts access to savings deposits," he adds. Kamath doesn't buy the contention of the foreign banks' lobby that they don't enjoy enough growth freedom. He in fact sees the current regulatory regime offering them "sufficient flexibility," and points out that the central bank has stated its resolve to be liberal in granting branch licenses. "The only major restriction for them is on the acquisition of existing banks, and that too will be revisited in the second stage of the roadmap that the RBI has set out (beginning March 2009)," he says. "Essentially, the question is not one of the country's openness but of whether foreign banks are willing to commit capital and enter the Indian market for the long haul."

Nayar points out that India isn't alone in opening up the banking sector as globalization advances, and that foreign investors are focused on the opportunities these throw up in many developing countries. "The RBI has a well-calibrated approach for opening up of the banking sector to foreign investors," he says of the central bank's phased and cautious approach. "Countries like Korea, Russia and Brazil have opened up their banking sectors significantly." India's banking industry has so far avoided a major financial crisis, unlike those in other developing countries, and that deserves a hand, says Nayar. "Indian banking has been relatively well managed and, more importantly, well regulated," he says. "Most of the other emerging economies have seen at least one period of significant turmoil in the last decade or so -- the Asian financial crisis in the late 1990s, the Latin American meltdown in 2001-02, and Mexico in the early 1990s."

Much now depends on how the RBI picks up the threads three years hence in 2009 when it reviews the progress achieved in the current opening-up phase. Boston Consulting Group's Sinha says the best course of action is to allow foreign banks entry into India up to a level that can be fixed in a variety of ways. "The Australians have a four-pillar policy where their biggest four banks cannot buy each other or be ought by foreigners" In India, says Sinha, this could the State Bank of India, the Life Insurance Corporation of India (an insurer and not a commercial bank) and three other players who in turn would have consolidated with some smaller players Together they would control between 60 and 70% of total banking assets. This way, he says, all the constituents would be satisfied.

back to top (#top)

back to top [(#top)](#top)